

POLICY PAPER

Fair Value

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ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 122,000 members and 325,000 students throughout their careers, providing services through a network of 80 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move, in pursuit of new career opportunities. Our focus is on professional values, ethics and governance, and we deliver value-added services through our global accountancy partnerships, working closely with multinational and small entities to promote global standards and support.

We use our expertise and experience to work with governments, donor agencies and professional bodies to develop the global accountancy profession and to advance the public interest.

Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications. We champion opportunity, diversity and integrity, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting our global standards, and supporting our members wherever they work, we aim to meet the current and future needs of international business.

FOREWORD BY RICHARD AITKEN-DAVIES, PRESIDENT OF ACCA AND CHAIRMAN OF ITS FINANCIAL REPORTING COMMITTEE



Fair value has come in for more scrutiny and criticism in recent months than any accounting issue since inflation accounting in the 1970s. This policy paper is ACCA's attempt to shed some light rather than the heat which has characterised much of the debate so far.

ACCA supports the concept of fair value and does not believe that accounting caused the credit crisis. The fact that it is the only realistic method of accounting for derivatives and getting them on the balance sheet is evidence enough of its worth. The application of principles-based systems should be encouraged. But we do accept that the problem of reliability of values in illiquid markets is great enough not to call for any extension of fair value with the International Financial Reporting Standards regime at present.

There are many questions here for the standard-setters. Above all, the crisis has shown the urgent need for clarification on the purpose of accounts so that expectations from different stakeholders can be met. But the International Accounting Standards Board should never again be put in the position of having to abandon due process under political pressure. That way lies the demise of much-needed global standards.

This paper takes forward some of the issues raised in ACCA's earlier paper *Climbing out of the Credit Crunch*, published in October 2008.
www.accaglobal.com/pdfs/credit_crunch.pdf

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INTRODUCTION

Accounting has rarely been so high-profile politically. Fair value accounting rules and the part they have supposedly played in the global credit crunch formed one of the first items for discussion at the November 2008 G20 summit of world leaders. Politicians in the US and Europe became engaged in the debate throughout the second half of last year and, in October 2008, successfully pressed the International Accounting Standards Board (IASB) to ease its fair value requirements. It seems, just as after the 2001 Enron collapse, financial reporting only becomes noticed during times of trouble.

The involvement of politicians came after heavy lobbying by banks and other financial institutions, which put some of the blame for their financial problems on fair value accounting, enshrined in standard IAS39 and the comparable US requirement in the Financial Accounting Standards Board's (FASB) standards. In fact, it was merely the latest chapter in a series of such controversies between standard-setters and financial institutions in recent years. In 2004, European banks lobbied national politicians about the effects of IAS39, parts of which (to do with hedge accounting) were subsequently 'carved out' of the standard and made optional for EU companies.

CONTEXT

The scale of political disquiet may suggest that fair value affects more businesses than is actually the case in practice. For industrial and commercial companies, however, most items will typically be accounted for on a cost-based measure. Banks naturally have greater financial holdings, which in normal times have an identifiable market, but even so, many banks are still using predominantly cost-based measures.

It is true, however, that fair value tends to reflect bad news somewhat unmercifully. It requires companies to mark their financial instruments at market prices and if this price is far lower than the original cost then it will lead to large write-downs on balance sheets. Confidence in these institutions may consequently be damaged. This is very different to reporting the instruments by using amortised cost, under which there is no need to report write-downs, unless the value of expected future cash flows is estimated to be less than historical cost.

And it may be that in current economic conditions, there is no 'market' to provide a value at all. Where there are no objective market values then so-called 'valuation techniques' can be used. The US FASB has developed a three-tier system: quoted prices, 'market-derived' values (ie from transactions in non-active markets) and unobservable inputs to valuation models.

The banks' main problem in the current credit crisis concerns those financial instruments that they hold for which there used to be an active market (such as mortgage-backed securities) but where, in a short period

of time, the market has ceased to exist. This makes valuation difficult, forcing them to make more use of mark-to-model valuations based on the prices from the few trades, possibly forced sales, taking place. It also means that assets that had been originally held for trading now have to be retained, with any value now dependent on prospective interest income.

In mid-2008 European banks therefore lobbied politicians to force the IASB's hand. By October, the IASB agreed, given the exceptional circumstances, to allow some limited reclassifications under IAS39, which had the effect of limiting write-downs that would otherwise have been necessary.

IAS39 is a complex standard, partly because it includes four categories of assets:

- held for trading
- available for sale
- held to maturity
- loans and receivables.

The first two categories are measured in effect at market value, while the last two are measured on an historical cost basis. The changes agreed by the IASB allowed the banks to switch some assets from the 'held for trading' category into others.

This move, European finance ministers claimed, equated to the more favourable treatment that US GAAP supposedly allowed US banks and so removed a competitive disadvantage. Nonetheless, the question remains: since the banks had previously categorised their instruments to their best advantage in good times, was it appropriate that they be allowed to change when the good times turned bad?

ADVANTAGES

Among the advantages of fair value is that it is a clear concept – the value that a business could get by selling or settling the item now. It may, of course, not end up taking that course of action but it should be recalled that the items stated at fair value are only those held for trading, available for sale or that the entity chose to state at fair value.

Fair values are inherently more transparent. When based on quoted prices in liquid markets they often require fewer assumptions than impaired historical cost, for example. They are also transparent in the sense that the position – good or bad – is out in the open. Particularly when values are falling, there is no sense in which problems of declines in value are being swept under the carpet in the hope that things will pick up later. The example of Japanese banks in the 'lost decade' of the 1990s is being cited as an example of when fair values were not used and the problems of over-inflated property and share stakes were disguised by the accounting.

Fair value also has the advantage of being a more information-rich concept, given that it is a market-based value representing the outcome of the views of all the market participants, not just of one such participant, namely the reporting company (historical cost being specific to a single entity).

Critics have complained that fair values are overly subject to manipulations to show the result management would like. In practice, however, the main alternative to fair value is historical cost, which can arguably be even more subject to 'earnings management'. For investments at historical cost but with a readily realisable value, the amount of profit is greatly influenced simply by whether or not management has chosen to sell the assets in the period. Profit or loss can be manufactured by 'churning' the assets.

The rapid development of derivative contracts meant that under a cost-based system a whole range of assets and perhaps liabilities were not on the balance sheet at all because they had little or no cost, though they could gain or lose value subsequently as circumstances (interest rates, exchange rates, commodity prices, etc) changed. Fair value was the only realistic way of getting these transactions on to the balance sheet and openly disclosed.

Some of the complexities associated with having several different categories for financial instruments – for instance the problems of defining boundaries between the categories and the problems of whether to allow reclassifications or not – could be avoided if there were to be a single basis for measuring these assets and liabilities. Given the position with derivatives, it is probably realistic to say that fair value is the only credible single basis. Nonetheless, the principle of a single basis, a full fair value model, is not yet generally accepted. Clearly, more needs to be done to underpin the credibility of fair value before the concept is extended further.

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The use of fair value to measure a good proportion of financial instruments in accounts is, however, widely accepted. Financial reporting for listed companies is all about supplying the needs of investors in capital markets. Major investors and their associations seem to support fair value as the most relevant information for them and no major investor bodies are calling for fair value to be scrapped or suspended or even to be used less. Indeed, the reverse tends to be the case – there have even been calls for all cost-based measures to be scrapped.

FAIR VALUE PLUSES

- Clarity
- Transparency
- Additional information
- Accounts properly for derivatives
- Less subject to 'earnings management'

FAIR VALUE MINUSES

- Problems of definition
- Adds to 'pro-cyclicality'
- Based on a price the entity has chosen NOT to sell at
- Difficult treatment of liabilities

PROBLEMS OF FAIR VALUE

One of the problems fair value has been defining the concept. The most recent proposals from the IASB would have consistently defined fair value as a current market exit value. This may be a useful tighter definition for many cases where fair value is used. There may, however, be other cases where a slightly different measure (say, an entry value including transaction costs) might be more appropriate, for example where it is being used as a substitute for cost. Fair value is itself one of the family of current-value measurement bases – others include replacement cost or value in use.

There are also objections to fair value in principle. It is the value a business could have obtained from selling an asset at the balance sheet date, but this is therefore a value that it chose NOT to sell at. So in the current circumstances fair value measures what the business would get by selling the asset today, whereas the historical cost model is based on what the business is actually intending to do with the asset, ie often to hold on to it and receive the interest, and if necessary impair the asset.

As fair value does not require a transaction to have occurred to recognise the change in value it can recognise profits and losses earlier than would the historical cost approach. Fair value risks overstating values and profits (leading to stronger balance sheets) when markets are rising but equally has a tendency to overstate the declines in value (hence weaker balance sheets) on the way down. This has led to criticism that fair value adds to so-called

‘procyclicality’ by amplifying the effects of the business cycle. Financial institutions have complained that fair value accounting has effectively been driving business behaviour rather than reflecting it – by encouraging banks to over-lend in good times while exaggerating their financial problems when the business cycle turns down. Although this tendency to follow the market has the advantage of transparency to investors, it may not produce the financial information most suitable for prudential supervision purposes.

Probably the biggest problem with fair value is the widespread concern over the reliability of values in illiquid markets

Another problem lies in the fair value treatment of liabilities. When a company’s credit rating deteriorates, many perceive a counter-intuitive effect which they find difficult to accept. A falling rating would lead to a decline in the fair value of a company’s bonds (ie its liabilities) for instance, and if they were included at fair value this would create a profit at a time when the company’s performance or prospects may have got worse. This is precisely what we have been seeing with some banks recently – amid the wash of red ink arising from their asset write-downs there have also been major gains for some as their bond values have declined.¹

This may be an example of how users of financial statements are not yet used to fair value accounting and so do not appreciate all its effects. As a result, they may not interpret fair values properly when analysing the company’s results. The IASB is working on a form of financial statement where the different sorts of gain and income are separately presented so the users can understand the numbers better.

Probably the biggest problem with fair value, however, is the widespread concern over the reliability of the values being used. Although few problems occur where there are quoted prices in liquid markets and transactions are taking place on a regular basis, moving from there to the models for valuation of unquoted instruments is a real step into uncertainty. Another issue of valuation exposed by the banking crisis has been the case where markets become illiquid or even close down – leaving the valuations even more uncertain, dependent as they may be on the few trades being done.

In short, as fair values move away from quoted prices in liquid markets the problems of reliability of these values multiply.

1. It should be pointed that IFRS restricts the use of fair value for liabilities to cases where the liabilities are held for trading or they are managed on the basis of the fair value.

ACCA’S POSITION

Fair values have significant advantages but raise problems as well. The IASB should require them, therefore, only in particular circumstances where the advantages outweigh the drawbacks. IFRS should continue to employ a mixture of cost and current-value measurement bases. Fair values have an important place in that system – especially in the accounting for financial instruments. We find that where existing standards mandate the use of fair value, these are generally appropriate. It is important that all derivatives are recognised at fair value, for instance.

The extent of the optional use of fair value has arguably been too wide. This has made the accounting for financial instruments harder to understand, comparability between entities even within the same sector has been diminished, and it has probably increased the use of less reliable values.

The IASB has been considering major extensions to the use of fair value – the full fair value model for financial instruments; in the valuation of obligations under insurance contracts and for revenue recognition generally.

Overall, we see no case for the extension of the use of fair values in accounting standards at present, particularly in areas where markets are non-existent or thin, such as partially complete sales or insurance contracts. The current crisis has highlighted the risks of using unreliable values. The IASB should not allow further classes of liabilities to be stated at fair value, beyond those currently permitted. Conversely, the IASB should not narrow the definition of fair value to a current market exit value, but permit some flexibility to allow that different sorts of current value might be needed in different circumstances.

ACCA does not believe that fair value accounting is a cause of the banking crisis. The calls for its suspension can be seen as trying to sweep the problems under the carpet, which would, if allowed, risk undermining the remaining confidence in the financial system. Some may not have accepted the answers produced by fair value accounting and therefore concluded that the method must be wrong. Others perhaps have believed the figures but considered the information too dangerous to be in the public domain.

There have also been criticisms that fair value has removed the role of the accountant’s judgement by allowing values to be dictated by whatever could be achieved in the market on a given balance sheet date. The process is still unfolding and only hindsight will tell us if the values for many of the instruments in question will turn out to be unrealistically low or about right.

The IASB should use the financial turmoil to establish its long-delayed conceptual framework for financial reporting

There are other arguments that should be noted. One is that that alternative values, such as historical cost, should also be disclosed in the accounts if fair value is being used so that users can make up their own minds on whether current, possibly depressed, prices accurately reflect true underlying value. The issue then would be whether this represents beneficial additional transparency or information overload. The IASB and FASB, both of whose standards have attracted criticism for length and complexity, could consider this point when continuing their convergence roadmap negotiations.

The current crisis has also raised the important issue of what the numbers in accounts are being used for. The banks have complained that fair value has combined unacceptably with the Basel 2 capital adequacy rules to increase pro-cyclicality. ACCA would argue that this is an issue for banking regulators to thrash out with standard-setters. IFRS financial statements and the fair values contained within them may not, however, be the ideal basis for prudential supervision of financial institutions. ACCA's view is that accounts are intended to inform shareholders on the affairs of the company, not provide a financial stability tool for regulators.

The IASB could use the financial turmoil as an opportunity to establish definitively its long-delayed conceptual framework for financial reporting. The fair value crisis has shown the need for clarification of the purpose of accounts so that expectations of stakeholders are appropriately set and a clear framework established for the improvement and application of standards. This would represent at least one positive outcome from an unprecedented financial crisis in which searching questions have rightly been asked of both accounting practice and the standard-setters.

The Global Economy

Addressing the challenges

There is a series of ACCA policy papers and other material related to global economic conditions available for download on a dedicated microsite, launched by ACCA in February 2009.

www.accaglobal.com/economy covers a range of topics including corporate governance, risk management, internal and external audit, financial reporting and SME issues.

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